

BEFORE THE TENNESSEE STATE BOARD OF EQUALIZATION

IN RE: Wells Real Estate Fund I)
a/k/a Black Oak Plaza Shopping Center) Knox County
Parcel ID #38KD-11.02 & 38KD-13)
Commercial Property)
Tax Year 2005)

INITIAL DECISION AND ORDER

Statement of the Case

The subject property is presently valued at \$3,271,400 as follows:

	<u>TOTAL VALUE</u>	<u>ASSESSMENT</u>
Parcel 11.02	\$2,667,900	\$1,067,160
Parcel 13	\$ 603,500	\$ 241,400

An appeal has been filed on behalf of the property owner with the State Board of Equalization. The undersigned administrative judge conducted a hearing in this matter on February 1, 2006 in Knoxville, Tennessee. In attendance at the hearing were registered agent Byron C. Pearce and Knox County Property Assessor's representatives Ralph E. Watson and Jim Beck.

FINDINGS OF FACT AND CONCLUSIONS OF LAW

Subject property consists of the Black Oak Plaza Shopping Center located on Maynardville Pike in Knoxville, Tennessee.

The taxpayer contended that subject property should be valued at \$2,740,100. In support of this position, a pro forma income approach was introduced into evidence. The taxpayer's contended income approach utilized the historical operating history of subject property in arriving at a stabilized estimate of net operating income.

The assessor contended that subject property should be valued at \$3,271,400. In support of this position, the assessor for all practical purposes sought a directed verdict. The assessor essentially asserted that the taxpayer's income approach does not reflect the market and therefore does not constitute a reliable indicator of value.

The basis of valuation as stated in Tennessee Code Annotated Section 67-5-601(a) is that "[t]he value of all property shall be ascertained from the evidence of its sound, intrinsic and immediate value, for purposes of sale between a willing seller and a willing buyer without consideration of speculative values . . ."

General appraisal principles require that the market, cost and income approaches to value be used whenever possible. Appraisal Institute, *The Appraisal of Real Estate* at 50 and 62. (12th ed. 2001). However, certain approaches to value may be more meaningful than others with respect to a specific type of property and such is noted in the correlation of value indicators to determine the final value estimate. The value indicators must be judged in three categories: (1) the amount and reliability of the data collected in each approach; (2)

the inherent strengths and weaknesses of each approach; and (3) the relevance of each approach to the subject of the appraisal. *Id.* at 597-603.

The value to be determined in the present case is market value. A generally accepted definition of market value for ad valorem tax purposes is that it is the most probable price expressed in terms of money that a property would bring if exposed for sale in the open market in an arm's length transaction between a willing seller and a willing buyer, both of whom are knowledgeable concerning all the uses to which it is adapted and for which it is capable of being used. *Id.* at 21-22.

In view of the definition of market value, the income-producing nature of the subject property and the age of subject property, generally accepted appraising principles would indicate that the market and income approaches have greater relevance and should normally be given greater weight than the cost approach in the correlation of value indicators.

After having reviewed all the evidence in the case, the administrative judge finds that the subject property should be valued at \$3,271,400 based upon the presumption of correctness attaching to the decision of the Knox County Board of Equalization.

Since the taxpayer is appealing from the determination of the Knox County Board of Equalization, the burden of proof is on the taxpayer. See State Board of Equalization Rule 0600-1-.11(1) and *Big Fork Mining Company v. Tennessee Water Quality Control Board*, 620 S.W.2d 515 (Tenn. App. 1981).

The administrative judge finds that the threshold issue in this appeal concerns the minimum evidence the appealing party must introduce to establish a prima facie case. As will be discussed below, the administrative judge finds that the taxpayer's proof in this appeal was insufficient to establish a prima facie case. Indeed, the taxpayer's methodology was strikingly similar to that utilized by another representative in a series of Washington County appeals wherein the administrative judge found the assessor was entitled to directed verdicts. See, e.g., *Scharfstein Investments* (Washington Co., Tax Year 2004).

The administrative judge finds that the taxpayer's proof must initially be rejected because the cost and sales comparison approaches were not even addressed. The administrative judge recognizes that in certain instances one or more approaches to value must be considered inapplicable. Similarly, the administrative judge understands that there are situations when the income approach properly receives greatest weight when reconciling the various indications of value. However, the administrative judge finds that all three approaches must at least be considered in order to arrive at a reliable conclusion of value. As stated in one authoritative text:

All three approaches are applicable to many appraisal problems, but one or more of the approaches may have greater significance in a given assignment. . . .

Appraisers should apply all the approaches that are applicable and for which there is data. The alternative value indications derived can either support or refute one another.

Appraisal Institute, *The Appraisal of Real Estate* at 62 (12th ed. 2001).

The administrative judge finds that even if the income approach was properly the only approach to consider, the taxpayer's income approach cannot be adopted as the basis of valuation for two fundamental reasons. First, as will be discussed in greater detail below, the income approach was incomplete. Second, the income approach actually constituted a leased fee valuation whereas the Assessment Appeals Commission ruled in *First American National Bank Building Partnership* (Davidson Co., Tax Years 1984-1987) that it "is the entire fee simple unencumbered value and not any lesser or partial interests" which is normally subject to taxation. Final Decision and Order at 3.

The administrative judge finds that Mr. Pearce arrived at his estimate of net operating income by stabilizing subject property's historical gross income. The administrative judge finds that no local market data or industry data was introduced to establish that the historical incomes, vacancies or expenses were representative of market norms.

The administrative judge finds that the procedure typically followed in the income approach has been summarized in one authoritative text as follows:

Assessing the earning power of a property means reaching a conclusion regarding its net operating income expectancy. The appraiser estimates income and expenses after researching and analyzing the following:

- The income and expense history of the subject property
- Income and expense histories of competitive properties
- Recently signed leases, proposed leases, and asking rents for the subject and *competitive properties*
- Actual vacancy levels for the subject and *competitive properties*
- Management expenses for the subject and *competitive properties*
- Published operating expense data and operating expenses at the subject and *competitive properties*

* * *

[Emphasis supplied]

Appraisal Institute, *The Appraisal of Real Estate* at 509 (12th ed., 2001). Respectfully, the administrative judge finds that Mr. Pearce's income approach initially lacks probative value because he ignored the market.

The administrative judge finds that Mr. Pearce's income approach must also be rejected because of insufficient evidence concerning whether subject property's actual

operating history is indicative of what a potential buyer would assume in projecting future net operating income. The Appraisal Institute addresses this concept in relevant part as follows:

To apply any capitalization procedure, a reliable estimate of income expectancy must be developed. Although some capitalization procedures are based on the actual level of income at the time of the appraisal, all must eventually consider a projection of future income. An appraiser must consider the future outlook both in the estimate of income and expenses and in the selection of the appropriate capitalization methodology to use. Failure to consider future income would contradict the principle of anticipation, which holds that value is the present worth of future benefits.

Historical income and current income are significant, but the ultimate concern is the future. The earning history of a property is important only insofar as it is accepted by buyers as an indication of the future. Current income is a good starting point, but the direction and expected pattern of income change are critical to the capitalization process.

Id. At 497.

The administrative judge finds that the problem with simply relying on historical operating history is best illustrated by the taxpayer’s own proof. The administrative judge finds that Mr. Pearce’s assumed rental rates of \$7.00 and \$7.50 per square foot for the shop space appear reasonable based upon historical data. Yet, Mr. Pearce’s own exhibit shows that on January 1, 2005 an informed buyer would almost certainly assume higher rental rates in projecting future net operating income.¹ The administrative judge has summarized below in chronological order the leases signed in 2004 and 2005 as indicated in the taxpayer’s exhibit:

<u>Lease Date</u>	<u>Lessee</u>	<u>Square Footage</u>	<u>Rental Rate</u>
7/1/04	Curves	2,450	\$ 7.00
10/18/04	UPS	1,190	\$ 7.00
10/22/04	J & J	2,800	\$ 7.00
11/1/04	Malibu Tan	2,000	\$ 7.00
3/1/05	GNC	2,000	\$10.50
3/1/05	Cutting Crew	1,050	\$ 8.49
4/21/05	Gatti’s	6,360	\$11.87
6/1/05	Sally Beauty Supply	1,600	\$ 9.25
1/1/05	Big Oak	1,600	\$ 9.00

The administrative judge finds that rental rates unquestionably were on the increase in 2005.

¹ Normally, post-assessment date events are not relevant. See *Acme Boot Co. & Ashland City Industrial Corp.* (Assessment Appeals Commission, Cheatham Co., Tax Year 1989). However, post-assessment date events have been allowed into evidence to confirm what could have reasonably been assumed on the assessment date. See, e.g., *George W. Hussey* (Assessment Appeals Commission, Davidson Co., Tax Year 1992). Similarly, post-assessment date sales have been allowed into evidence to show a trend in values. See, e.g., *Christine Hopkins* (Assessment Appeals Commission, Franklin Co., Tax Years 1995 and 1996).

The administrative judge finds that Mr. Pearce’s income approach must also be rejected because no evidence whatsoever was introduced in support of his assumed base capitalization rate of 10%. The administrative judge finds that in response to his query, Mr. Pearce stated that he chose that rate based upon his “experience.” Respectfully, the administrative judge finds that a registered agent’s experience standing by itself does not constitute sufficient evidence to establish a capitalization rate.

The administrative judge would also note that Mr. Pearce’s analysis was apparently greatly influenced by what he was told by the property owner. For example, the cover page to exhibit 1 states in relevant part as follows:

- 2. The Center has struggled for the last several years with high vacancy (exceeding 30%). The owner reports that retail activity has centered around the CBD and the western edge of the city Black Oak Plaza is located in the north sector away from the retail development focus.
- 3. Asking rents for vacant space is \$6.50-\$7.00/SF (See attached) due to the factors referenced in item #2.

The administrative judge finds Mr. Watson’s testimony indicated that subject property is located in the second fastest growing area of Knox County. The administrative judge finds that examples of recently constructed and remodeled centers in the Halls area were offered into evidence by the assessor. Mr. Watson also noted that the taxpayer’s contention of value is even lower than the value adopted by the State Board of Equalization in 1997.

Based upon the foregoing, the administrative judge finds that the taxpayer introduced insufficient evidence to establish a prima facie case. Accordingly, the administrative judge finds that the current appraised value of \$3,271,400 must be presumed correct.

ORDER

It is therefore ORDERED that the following values and assessments be adopted for tax year 2005:

	<u>TOTAL VALUE</u>	<u>ASSESSMENT</u>
Parcel 11.02	\$2,667,900	\$1,067,160
Parcel 13	\$ 603,500	\$ 241,400

It is FURTHER ORDERED that any applicable hearing costs be assessed pursuant to Tenn. Code Ann. § 67-5-1501(d) and State Board of Equalization Rule 0600-1-.17.

Pursuant to the Uniform Administrative Procedures Act, Tenn. Code Ann. §§ 4-5-301—325, Tenn. Code Ann. § 67-5-1501, and the Rules of Contested Case Procedure of the State Board of Equalization, the parties are advised of the following remedies:

- 1. A party may appeal this decision and order to the Assessment Appeals Commission pursuant to Tenn. Code Ann. § 67-5-1501 and Rule 0600-1-.12 of the Contested Case Procedures of the State Board of Equalization. Tennessee Code Annotated § 67-5-1501(c) provides that an appeal “**must be**

filed within thirty (30) days from the date the initial decision is sent.”

Rule 0600-1-.12 of the Contested Case Procedures of the State Board of Equalization provides that the appeal be filed with the Executive Secretary of the State Board and that the appeal **“identify the allegedly erroneous finding(s) of fact and/or conclusion(s) of law in the initial order”**; or

2. A party may petition for reconsideration of this decision and order pursuant to Tenn. Code Ann. § 4-5-317 within fifteen (15) days of the entry of the order. The petition for reconsideration must state the specific grounds upon which relief is requested. The filing of a petition for reconsideration is not a prerequisite for seeking administrative or judicial review; or
3. A party may petition for a stay of effectiveness of this decision and order pursuant to Tenn. Code Ann. § 4-5-316 within seven (7) days of the entry of the order.

This order does not become final until an official certificate is issued by the Assessment Appeals Commission. Official certificates are normally issued seventy-five (75) days after the entry of the initial decision and order if no party has appealed.

ENTERED this 21st day of February, 2006.

MARK J. MINSKY
ADMINISTRATIVE JUDGE
TENNESSEE DEPARTMENT OF STATE
ADMINISTRATIVE PROCEDURES DIVISION

c: Mr. Byron C. Pearce
John R. Whitehead, Assessor of Property